

PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE

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July 18, 2006

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and

Alternate Agenda ID #5842

Ratesetting

TO: PARTIES OF RECORD IN RULEMAKING (R.) 04-01-025, R.02-06-041,
APPLICATION (A.) 00-06-023 AND A.02-10-040

These are the proposed decision of Administrative Law Judge (ALJ) Kim Malcolm, previously designated as the principal hearing officer in this proceeding and the alternate proposed decision of President Michael R. Peevey. The proposed decision and the alternate decision will not appear on the Commission's agenda for at least 30 days after the date it is mailed.

Pub. Util. Code § 311(e) requires that the alternate item be accompanied by a digest that clearly explains the substantive revisions to the proposed decision. The digest of the alternate proposed decision is attached.

This matter was categorized as ratesetting and is subject to Pub. Util. Code § 1701.3(c). Upon the request of any Commissioner, a Ratesetting Deliberative Meeting (RDM) may be held. If that occurs, the Commission will prepare and publish an agenda for the RDM 10 days beforehand. When an RDM is held, there is a related ex parte communications prohibition period. (See Rule 7(c)(4).)

When the Commission acts on these agenda items, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure," accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages.

Comments must be filed with the Commission's Docket Office. Comments should be served on parties to this proceeding in accordance with Rules 2.3 and 2.3.1. Electronic copies of comments should be sent to ALJ Malcolm at kim@cpuc.ca.gov. All parties must serve hard copies on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail or other expeditious methods of service. The current service list for this proceeding is available on the Commission's web site, www.cpsc.ca.gov.

/s/ ANGELA K. MINKIN

Angela K. Minkin, Chief
Administrative Law Judge

ANG:h12

Attachment

ATTACHMENT
Digest of Alternate Proposed Decision

R.04-01-025 et al.: Re: Petitions to modify Decisions (D.) 05-10-043, D.05-10-015, D.04-01-047, D.02-06-023 and D.03-07-037 regarding gas hedging for the 2006-2007 winter season for Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCalGas), and San Diego Gas & Electric Company (SDG&E).

Pursuant to Pub. Util. Code Sec. 311(e), the digest of the substantive differences between the proposed decision of Administrative Law Judge Malcolm and the alternate proposed decision of President Peevey is as follows:

PG&E, SoCalGas, and SDG&E filed petitions for modification of various decisions, proposing to exempt purchases of hedging instruments from the rewards and penalties associated with the incentive mechanisms. The utilities state that they intend to purchase hedging instruments to protect ratepayers from fuel price spikes this coming winter. The petitions also request approval of specific natural gas hedging plans and ask that all of the costs and benefits of the expanded hedging plans, and the gas hedging that has already taken place for the 2006-07 winter season, be allocated directly to core gas procurement customers.

Proposed Decision

The proposed decision declines to approve the confidential hedging plans proposed by PG&E, SoCalGas and SDG&E. The proposed decision requires that a portion of all purchases of hedging instruments be included as part of each utility's incentive mechanism. The authority provided in the proposed order allows each utility to account for 75% of hedging purchases outside its incentive mechanism and applies to all hedging purchases made for the 2006-07 winter season. The remaining 25% is to be included within the incentive mechanism. This accounting approach is authorized only for hedging purchases that cover gas costs during the winter months of 2006-07. Once selected, each utility must account for all hedging purchases using this allocation approach. Each utility must inform the Commission's Executive Director in writing no later than 15 days from the effective date of this order of whether or not it will take advantage of this option, rather than accounting for all hedging within its incentive mechanism. Once this notice has been provided, the utility's decision shall not be revocable. Each utility is authorized to spend up to but not more than \$14 per customer for hedging purchases if it chooses to account for 75% of

hedging purchases outside of incentive mechanisms. This limitation shall not include hedging instruments commonly known as “swaps.” The proposed decision also requires that reports be submitted to the ALJ and the Energy Division and that these reports be made public.

Alternate Proposed Decision

1. The alternate proposed decision approves the confidential hedging plans of PG&E, SoCalGas and SDG&E1 for the 2006/2007 winter season in the manner requested by the utilities. The authorization provided in the alternate proposed decision will result in an increase for average residential customer's monthly bill by approximately \$2.00.

The proposed alternate decision grants the emergency petitions and modifies the impacted decisions to authorize supplemental hedges in 2006-07. The level of the hedges and the expiration dates are contained in the confidential hedging plans. Costs, including costs incurred for hedging already entered into, are allocated to core gas procurement ratepayers. No costs or benefits are allocated to shareholders. In addition, each utility is authorized to spend up to \$14 per core customer for the 2006/2007 winter season, or up to the amount requested in its petition for modification of D.05-10-015 on hedged instruments, whichever is lower. This limit shall not include hedging instruments commonly known as “swaps.” The alternate proposed decision requires that reports be submitted to the Division of Ratepayer Advocates and the Energy Division on a confidential basis.

(END OF ATTACHMENT)

¹ These hedging plans will remain confidential as there is highly sensitive market information involved and if released, could work toward the detriment of utilities' ratepayers.

Decision **PROPOSED ALTERNATE DECISION OF PRESIDENT PEEVEY**
(Mailed 07/18/2006)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Rules to Ensure Reliable, Long-Term Supplies of Natural Gas to California.

Rulemaking 04-01-025
(Filed January 22, 2004)

Order Instituting Rulemaking to Require California Natural Gas and Electric Utilities to Preserve Interstate Pipeline Capacity to California.

Rulemaking 02-06-041
(Filed June 27, 2002)

In the Matter of the Application of Southern California Gas Company Regarding Year Six (1999-2000) Under Its Experimental Gas Cost Incentive Mechanism and Related Gas Supply Matters. (U 904 G)

Application 00-06-023
(Filed June 15, 2000)

In the Matter of the Application of San Diego Gas and Electric Company (U 902 G) to Modify and Extend Permanent Gas Procurement Performance-Based Ratemaking Mechanism.

Application 02-10-040
(Filed October 31, 2002)

**OPINION MODIFYING DECISIONS 05-10-015 AND 05-10-043
IN RESPONSE TO THE PETITIONS OF PACIFIC GAS AND ELECTRIC
COMPANY, SOUTHERN CALIFORNIA GAS COMPANY AND
SAN DIEGO GAS & ELECTRIC COMPANY**

I. Summary

This decision addresses the emergency petitions of Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCalGas) and San Diego Gas & Electric Company (SDG&E) to modify Decision (D.) 05-10-043, D.05-10-015, D.04-01-047, D. 02-06-023 and D.03-07-037. All three utilities seek to modify orders requiring them to account for all costs of natural gas procurement in their natural gas purchase incentive mechanisms. The utilities propose to exempt purchases of hedging instruments from the rewards and penalties associated with the incentive mechanisms. The purpose of the proposed modification would be to relieve the utilities of the risks associated with the purchase of hedging instruments for natural gas prices. The utilities intend to purchase hedging instruments to protect ratepayers from fuel price spikes this coming winter. The petitions also request approval of specific natural gas hedging plans and ask that all of the costs and benefits of the expanded hedging plans, and the gas hedging that has already taken place for the 2006-2007 winter season, be allocated directly to core gas customers.

The relief that the utilities request is similar to the relief that the Commission approved for all three utilities last winter season, which was sought and granted because of expected natural gas price spikes after Hurricane Katrina, and to a lesser degree from Hurricane Rita.

This decision approves the confidential hedging plans of PG&E, SoCalGas and SDG&E² for the coming 2006/2007 winter season in the manner requested — subject to hedging expenditure limits as described herein. In doing so, we will

² These hedging plans will remain confidential as there is highly sensitive market information involved and if released, could work toward the detriment of utilities' ratepayers.

remove the expenditures authorized today on financial hedging from the utilities respective natural gas purchase incentive mechanisms. This is important because it will allow the utilities to take on expanded hedging programs while aligning ratepayer and shareholder interests. The proposal we adopt today will go a long way in moderating the potential impact of natural gas price increases on residential ratepayers by providing the utilities with additional ability to purchase insurance against price spikes. Today's authorization will result in an increase for average residential customer's monthly bill by approximately \$2.00.

II. Background

In response to the events affecting the natural gas infrastructure resulting from Hurricane Katrina and because of rising natural gas prices, on September 13, 2005, PG&E filed an emergency petition for modification of its current Core Procurement Incentive Mechanism (CPIM) in D.04-01-047. After taking comments on PG&E's emergency petition, we adopted D.05-10-015 on October 6, 2005. D.05-10-015 authorized PG&E to purchase hedges as set forth in its confidential hedging plan for a total of three years. The order also approved, among other things, PG&E's request that the costs associated with the approved hedges be paid for by PG&E's core customers and that all payouts associated with the hedges flow directly to PG&E's core gas customers. In addition, PG&E agreed that its shareholders would forego any award for the 2004/2005 CPIM year.

Similarly, on October 11, 2005, SoCalGas and SDG&E filed an emergency petition to modify D.02-06-023 and D.03-07-037. In response, the Commission adopted D.05-10-043, which adopted the utilities' hedging plans and allocated all risks, costs, and benefits to their respective ratepayers.

PG&E filed the instant petition on May 5, 2006, seeking an order by June 15, 2006. SoCalGas and SDG&E filed their petitions on May 17, 2006, seeking an order by June 29, 2006. On May 26, 2006, The Utility Reform Network (TURN) and the Division of Ratepayer Advocates (DRA) filed responses to PG&E's petition. Neither filed responses to the petitions of SoCalGas or SDG&E although both participated in subsequent hearings.

On May 29, 2006, the assigned Administrative Law Judge (ALJ) issued a ruling in these proceedings that directed the utilities to respond in writing to a number of questions about their respective proposals, decision-making processes, and alternatives. Each utility served responses to the questions presented in the ALJ's ruling. The ALJ subsequently conducted two days of hearings on June 9 and June 16, 2006. At the hearing, the ALJ agreed that some of the information relevant to cross-examination was confidential because its public disclosure might affect the utilities' ability to purchase lowest-cost financial instruments. The ALJ therefore conducted portions of the hearing such that they were closed to the public and parties who had not signed nondisclosure agreements. The associated hearing transcripts were filed under seal.

PG&E, SoCalGas, SDG&E, TURN, Coral Energy Resources L.P. (Coral) School Project for Utility Rate Reduction (SPURR) and the ABAG Publicly Owned Energy Resources (ABAG Power), and DRA filed briefs on June 26, 2006 and filed reply briefs on June 30, 2006.

III. The Current Incentive Mechanisms

Each of the three utilities currently purchases natural gas on behalf of core ratepayers and accounts for those purchases in a regulatory mechanism that allocates liability between utility shareholders and ratepayers, providing an incentive for each to purchase low cost gas supplies. Each utility incentive

mechanism differs from the other to some extent but all are intended to provide incentives because shareholders are allocated a share of the gains or losses associated with natural gas purchases compared to a monthly market gas price benchmark. A “dead band” around the benchmark delineates the range of costs to be borne by ratepayers and shareholders. These incentive mechanisms replaced the reasonableness reviews of the utilities’ gas procurement activities that the Commission previously conducted. SoCalGas’ Gas Cost Incentive Mechanism (GCIM) was approved in D.02-06-023, and SDG&E’s Performance Based Ratemaking (PBR) was approved in D.03-07-037. The Commission approved the current version of PG&E’s CPIM in D.04-01-047.

All three utilities have argued that their respective gas purchasing incentive mechanisms discourage them from entering into arrangements that fix the prices of natural gas for an extended period of time, or expending dollars to hedge a significant portion of the company’s natural gas purchases on behalf of core gas customers. The utilities have hedged their core gas purchases to some extent for this year and in previous years. However, they contend that if their spending on hedges, such as option premiums, exceeds the upper level of the dead band in their procurement mechanisms, then their shareholders face the risk of large financial penalties.

IV. The Utility Proposals

PG&E, SoCalGas and SDG&E request substantially similar relief adopted in D.05-10-015 and D.05-10-043 to allocate all costs and benefits of hedging to their respective customers. Their petitions seek approval of specific hedging plans for the upcoming winter season only. Each utility explains that it would not be permitted to depart from the plan adopted here and that their respective investment decisions would not be subject to reasonableness reviews. Each plan

identifies a dollar ceiling to be spent on hedging instruments, the types of hedging instruments that would be purchased and generally over what period, exemplary “strike prices” for each purchase and the potential ratemaking impacts.

Although this decision does not disclose which hedging instruments the utilities intend to purchase, examples of hedging instruments include:

- *Call Options*: A financial instrument that gives the purchaser the right, but not the obligation, to purchase a NYMEX Henry Hub natural gas futures contract at a predetermined fixed price (or “strike price”) on or before a specific date (an “expiration date”)
- *Put Options*: A financial instrument that gives the purchaser the right but not the obligation to sell a NYMEX futures contracts at a predetermined fixed price on or before a specific date.
- *Futures*: A supply contract whereby the buyer is obligated to take delivery and the seller is obligated to provide delivery of a fixed amount of a commodity at a predetermined price at a specified location.
- *Basis Swaps*: A financial instrument that gives the buyer the obligation to pay or receive the value difference between the purchase price and the settled spread between the NYMEX Henry Hub futures and a defined locational index, such as the Natural Gas Intelligence SoCal index;
- *Fixed Price Swaps*: A financial instrument that gives the buyer the obligation to pay or receive the value difference between the purchase price and a natural gas index settlement price. It involves no up-front premium.

The utilities describe their hedging programs as “insurance” against natural gas price spikes. Each utility states it requires this authority in order to better protect their core customers from potential gas price spikes this winter. During the hearing, the utilities provided evidence that natural gas prices are increasing and, more significantly, that prices for natural gas are more volatile and unpredictable than in previous years.

The utilities seek authority to spend up to specified amounts on hedging instruments during winter 2006-07 and authority to engage in financial transactions that do not require dollar outlays in advance but which might result in additional losses. Without publicly disclosing the liabilities the utilities would incur on behalf of ratepayers, the dollar amounts are larger than amounts authorized in the past and would be used to hedge greater portions of their gas supplies. The utilities propose to purchase hedging instruments that would protect against higher prices and also “swaps,” which would permit ratepayers to benefit from market prices that are ultimately lower than the prices the utilities paid for existing gas supplies (and simultaneously expose ratepayers to substantial losses under some scenarios). Storage gas could also be hedged.

The utilities would retain authority to include the costs and benefits of hedging instruments within their existing incentive mechanisms at their discretion. The accounting for each individual instrument would be separate, depending on whether it was purchased within or outside the incentive mechanism.

All three utilities requested emergency treatment of their petitions in light of the impending hurricane season. Each seeks retroactive authority to be relieved of liability for any risks or costs associated with hedging instruments purchased since the lapse of authority the Commission granted last October. In

addition, of the three utilities, only PG&E has filed an application concurrently for long-term hedging mechanisms outside of its CPIM – A.06-05-007.

V. Parties' Responses To the Proposals

TURN and DRA filed responses to PG&E's petitions. They did not file responses to the petitions of SoCalGas or SDG&E because the filing date for the responses fell after the evidentiary hearing. TURN and DRA filed briefs to address their concerns and ideas after the hearings.

In its response to PG&E's petition, TURN states it generally supports utility hedging natural gas supplies but raised concerns about the lack of detail concerning the criteria used to determine hedging parameters and the analyses used to determine possible bill impacts. In its brief, TURN stated its support for the utility hedging proposals and urged quick approval of them. TURN believes hedging can provide important protection for ratepayers against price spikes. TURN proposes the Commission address the longer term issue in a rulemaking or the application PG&E recently filed for authority to adopt a long-term hedging plan.

In its response to PG&E's petition, DRA opposes PG&E's proposal, believing PG&E should conduct hedging activities in the context of its CPIM. It believes the dollar amounts PG&E wishes to spend on hedging instruments is "excessive" and the percentage of total gas supplies PG&E would hedge is too high. If the Commission permits PG&E to hedge outside the CPIM, DRA would propose the following conditions:

1. PG&E's dollar authority should be capped;
2. PG&E should not be allowed to hedge utilizing swaps;
3. The amount of gas PG&E should be permitted to hedge should be reduced substantially;

4. PG&E's lower CPIM dead band should be expanded to two percent;
and
5. The Commission should order PG&E to provide the Commission with a report no later than April 1, 2007 that would provide an ex post review of how PG&E's hedging program affected gas customers.

In addition, DRA proposes a compromise hybrid CPIM approach whereby the cost and returns associated with 25 percent of all hedges would be included in the CPIM and 75 percent be allocated outside the CPIM.

In its brief, DRA also opposes SDG&E's proposal. DRA believes SDG&E's budget for hedging is excessive and unwisely includes an unknown amount of potential losses associated with purchase of "swaps" or futures. It proposes the Commission limit SDG&E's spending on hedging instruments to a lower amount than requested, prohibit SDG&E from hedging in non-winter months and require SDG&E to submit a report that provides details about the results of hedging activities. DRA opposes any hedging outside of incentive mechanisms but proposes increases to the tolerance bands as a way of limiting shareholder exposure to risk. Alternatively, DRA proposes that 25% of hedging costs and returns be included in SDG&E's PBR, with the remaining 75% allocated directly to ratepayers.

DRA also filed a brief in opposition to SoCalGas' proposal. DRA recommends expanding the lower GCIM tolerance band to reduce shareholder exposure to risk and that SoCalGas be required to file a report detailing the results of its hedging activities. As for the other utilities, DRA opposes any hedging outside of incentive mechanisms but proposes a compromise that would include 25% of hedging costs and returns in the GCIM, with the remaining 75% allocated directly to ratepayers.

SPURR/ABAG Power oppose the utilities' proposals to be shielded from the risk of hedging. They observe that the utilities' proposals are not founded on information about what customers would be willing to pay for this type of insurance, and that hedging outside of incentive mechanisms eliminates the motivation for sound decision-making and transparent transactions.

SPURR/ABAG also raise concerns that DRA and TURN are not in a position to judge the merits of utility hedging strategies and do not necessarily represent the interests of non-residential customers. They propose that the utilities be required to disclose what they intend to hedge and the average cost at the beginning of each month and to disclose what they spent and gained or lost shortly after the winter 2006-07 period.

Coral Energy does not oppose the utilities' proposals but raises concerns that the gas incentive mechanisms may require modification to permit the utilities to make commitments for gas supplies in long term contracts. It also believes the Commission should explore the option of pre-approving annual gas procurement plans.

VI. Discussion

A. Emergency Nature of Petitions. We first address whether in fact the petitions make the case for emergency action by the Commission, as the utilities propose. We find that they do not. Last year, the Commission took emergency action on related utility petitions following an extraordinary event, namely, the devastation by Hurricane Katrina to the Gulf Coast, an area that produces and refines a substantial portion of the country's petroleum supplies. D.05-10-015 and D.05-10-043 found that Hurricane Katrina "had a major adverse impact on natural gas markets," disrupting sixteen percent of the natural gas production for the United States and resulting in a dramatic rise in gas prices. On this basis, we

took emergency action to relieve the utilities of liabilities associated with hedging and to encourage their purchase of hedging instruments to protect ratepayers. No events have occurred yet this year that would create an emergency circumstance. That said, we understand the time sensitive nature of hedging instruments and recognize that value of having hedges in place prior to catastrophic events affecting natural gas supply. We agree with TURN that a rational hedging strategy plans ahead and does not wait until something bad happens.

We note that the utilities already have authority to purchase hedging instruments within their respective incentive mechanisms, and, in the case of PG&E, to purchase hedging instruments outside their respective incentive mechanisms for this year and next. The petitions before ask authority to spend additional ratepayer funds on hedging instruments outside of existing regulatory mechanisms.

Our prior decisions authorizing additional hedging for the 2005/2006 winter were adopted after Hurricane Katrina struck – the emergency event. This year the utilities have come to us much earlier to seek additional hedging authorization for the upcoming winter. While no emergency event has yet occurred, in the hearings the utilities provided evidence that natural gas prices are increasing and, more significantly, that prices for natural gas are more volatile and unpredictable than in previous year. Given this backdrop, the prudent course of action is to act timely on the petitions before us and to provide utilities hedging direction prior to an adverse event.

B. The Need for Hedging Instruments for Natural Gas Supplies. The utilities have developed plans for purchasing hedging instruments on behalf of their respective ratepayers, arguing that hedging is a type of insurance against

the price impacts of catastrophic events such as Hurricane Katrina and market volatility generally. The utility petitions explain why existing incentive mechanisms do not provide motivation for them to purchase what they believe are optimal investments in hedging instruments, namely, that hedging instruments generally present shareholders with too much risk. Each utility has purchased hedging instruments over the years as part of its natural gas portfolios and subject to its incentive mechanism. Each utility intends to continue to purchase some hedging instruments within its incentive mechanisms.

In October 2005, the Commission approved the utilities' emergency requests for authority to purchase hedging instruments outside of their incentive mechanisms following a devastating hurricane that affected national prices for natural gas. At the time, we found it prudent for the utilities to engage in additional hedging outside of their existing incentive mechanisms. We rejected DRA's arguments that a simple widening of the incentive mechanisms' dead band would provide adequate incentives for additional hedging while protecting ratepayers' interests. Instead, we agreed with TURN that protecting consumers from further price run-ups outweighs the cost of the hedges. The estimated cost of the authorized hedges was about \$2.00 per customer per month. We acknowledged the importance of re-examining the incentive mechanisms in light of current conditions and the potential for high natural gas prices over the next few years. To that end, PG&E concurrently filed for authority to adopt a long-term hedging plan, A.06-05-007. We encourage all of our other natural gas utilities to do likewise.

This year the utilities want to spend more on hedging instruments and plan to hedge larger proportions of their total portfolios. The utilities cite the increased volatility in the current natural gas market – which they have

demonstrated to our satisfaction. Prior to filing their applications, the utilities engaged both TURN and DRA in discussions over the past several months regarding potential hedging plans in an attempt to reach a consensus agreement on hedging strategy. Though considerable information was provided by the utilities to TURN and DRA, no agreement was reached. The utilities have offered to allow TURN and DRA to monitor any hedging activities approved by the Commission. TURN supports the utilities applications.

Hedging is a form of insurance that protects ratepayers from price spikes in the natural gas markets. An effective hedging strategy plans ahead and does not wait for an adverse event to occur before being enacted. While the circumstances under which the utilities applications have been filed are different this year than last year, the threat of price spikes this winter cannot be ruled out. Prudence dictates that we act now, instead of reacting to an unforeseen event.

C. Utility Hedging Plans. Each utility petition provides an outline of a hedging plan. Each plan provides information about the types of instruments the utilities might purchase, the dollars they will spend, strike prices, the amount and type of gas they would hedge and the impact on utility rates. Each utility presented highly qualified and credible experts at the Commission hearing who explained each program element in response to questions and described the various hedging instruments they might purchase. The utilities seek Commission approval of these hedging plans. They have shared and discussed their plans with, and state their intent to provide ongoing program information to the Energy Division, DRA and TURN.

The utilities state that their existing incentive mechanisms do not provide adequate motivation for them to invest in hedging mechanisms at a level that might be optimal to protect ratepayer interests. Their witnesses explained that

hedging has become increasingly risky and expensive. They also state that the incentive mechanisms do not align ratepayer interests with shareholder interests; that is, shareholders may be in a position of “winning” when market prices go up, and conversely shareholders would lose when prices fall.

DRA recommends that the utilities perform all hedging activities within their incentive mechanisms. But if the Commission were to allow hedging outside of these mechanisms, then DRA states that the tolerance bands should be increased. SPURR and ABAG Power take no position on the alignment of ratepayer and shareholder interests under the existing mechanisms. SPURR and ABAG Power oppose the utilities’ proposals to be shielded from the risk of hedging and state that “...to the extent interests are aligned under the existing incentive mechanisms, the use of hedging transactions does not change that alignment.” TURN supports the utilities’ applications and recommends their approval.

We find that the existing incentive mechanisms may not be designed to accommodate hedging activities that might be reasonable given changing market conditions. The utilities make a reasonable case that they may not be able to justify the shareholder risk that could be implicated if they were to engage in an optimal amount of hedging within their respective incentive mechanisms. The utilities have generally opposed increasing the tolerance bands for their incentive mechanisms on the basis that the change could reduce their prospects for shareholder awards. TURN agrees with this rationale.

In line with D.05-10-015, D.05-10-043 stated “...we should not put SoCalGas and SDG&E in a position in which their purchasing of additional hedging instruments to protect core customers could result in large financial penalties for their shareholders.” The record here provides little analysis of the potential impacts of increasing the tolerance bands under different scenarios and

in light of our past decisions rejecting the increase in tolerance bands in the utility incentive mechanisms, we see no reason to do so now. For this reason, we reject DRA's proposal of a "compromise hybrid approach" whereby 25% of the hedges would be included in the incentive mechanisms, with the remaining 75% to be allocated outside of the incentive mechanisms. This and other ratemaking alternatives may deserve additional consideration in the utilities' applications for a permanent hedging ratemaking mechanism.

Because the record is unclear as to what amounts the utilities are proposing and the associated liabilities ratepayers would assume, we are unable to adopt the utilities' proposed dollar caps as contained in their respective petitions. To address this issue, we instead limit hedging expenditures to \$14 per core customer for the 2006-2007 winter season, or to the utilities' proposed expenditure amounts – whichever is lower. By doing so, ratepayers' liability for additional hedging is capped. Plus, this amount provides adequate funding for hedging and is reasonable until and unless we have information about utility customers' willingness to pay for gas hedging. We note that in the decisions approving additional hedging for 2005/2006, the estimated dollar impact was \$2 per month per customer – similar to the amount we are approving today. We have no objection to the utilities' plans to engage in "swaps," and the hedging expenditures we are approving today would not include swap instruments, which do not have pre-paid premiums.

We agree with DRA that each utility should be directed to provide a report of the results of their hedging programs for the 2006-2007 winter season. The reports will provide some evidence to evaluate the merits of the programs and will be useful in guiding future ratemaking and policy in this area. The reports should provide detailed information including, but not limited to, the following information:

Total funds spent on hedging instruments;
Total losses and gains for each category of hedging instrument;
Amount of natural gas supplies hedged monthly; and
Impact of hedging program on utility rates.

The utilities should provide this information to DRA and the Commission's Energy Division by April 1, 2007. The utilities should continue provide DRA and the Energy Division with others reports on hedging activities that (1) they currently provide, and (2) as requested by DRA and Energy Division.

VII. CONCLUSION

In sum, this order resolves the utilities' petitions as follows:

- Approves the utilities' hedging plans for the 2006/2007 winter period only;
- Approves the utilities' requests for authority to account for 100% of the costs and benefits of hedging instruments outside their respective incentive mechanisms at their discretion;
- Authorizes each utility to spend up to \$14 per core customer for the 2006-2007 winter season, or up to the amounts requested in their respective petitions on hedged instruments – whichever is lower. This limit shall not include hedging instruments commonly known as "swaps."
- Requires each utility to provide the Commission a report no later than April 1, 2007 that provides information about the costs and benefits of the program in the aggregation, funds expended by category of purchase, impacts on utility rates and the amounts of gas hedged in each purchasing period.

We proceed to consider these matters further for PG&E in its application for a longer term ratemaking program for natural gas hedging activities in A06-05-007. We encourage SoCalGas and SDG&E to file similar applications.

Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner. Kim Malcolm is the assigned ALJ in R.04-01-025, R.02-06-041, A.00-06-023, and A.02-10-040 for the purpose of resolving the emergency petitions.

Comments on Alternate Draft Decision

The Commission mailed the alternate draft decision of President Peevey in this matter on July 18, 2006, in accordance to Public Utilities Code § 311(d) of the Public Utilities Code and Rule 77.1 of the Rules of Practice and Procedure.

Parties filed comments on _____ and reply comments on _____.

Findings of Fact

1. The utilities requested a schedule for expedited action in this proceeding that would require the Commission to make exceptions to procedural requirements of the Public Utilities Code and the Commission's Rules of Practice and Procedure.
2. The utilities have not made a compelling showing that any emergency exists that requires immediate authorization of the utilities' petitions.
3. The utilities provided evidence that natural gas markets have become increasingly volatile, which has increased the costs of and the risks associated with purchasing hedging instruments.
4. Compared to last winter, the utilities propose to insure larger portions of their natural gas supply portfolios and to commensurately spend larger sums on hedging instruments.
5. It is in the best interest of ratepayers for the utilities to take proactive steps to mitigate natural gas prices, and to do otherwise runs the risk of even higher winter natural gas rates.

6. The utilities have shared and discussed their hedging plans with TURN and DRA prior to filing their petitions.

7. TURN supports the hedging plans as filed, while DRA does not.

8. The existing incentive mechanisms may not be structured in ways to motivate optimal purchases of hedging instruments on behalf of ratepayers.

9. The utilities should not be placed in a position where the purchasing of additional hedging instruments to protect core customers could result in large financial penalties for their shareholders.

10. The record does not provide clear information about the amounts of ratepayer funds the utilities propose to use for hedging.

11. The hedging plans of PG&E, SoCalGas and SDG&E are an appropriate response for the 2006-2007 winter season.

12. The hedging plans we adopt today will increase the average residential monthly bill by approximately \$2.00.

Conclusions of Law

1. Section 311 requires the Commission to publish proposed decisions at least 30 days before adopting them except in certain specified circumstances. Section 311(g)(2) permits a waiver of the 30 day publication period in cases of unforeseen emergency, a condition that is not met in this case.

2. The hedging plans of PG&E, SDG&E and SoCalGas should be approved, and the request to modify Decisions (D.) 05-10-015, D.04-01-047, D.05-10-043, D. 02-06-023 and D.03-07-037 in the manner requested by the utilities should be granted.

3. Since the petitions only seek authority for expanded hedging activities for the 2006-2007 winter, and are not seeking a permanent change to the incentive mechanisms, today's expanded hedging authority and modification of D.05-10-

015, D.04-01-047, D.05-10-043, D. 02-06-023 and D.03-07-037 should be limited to the 2006-2007 winter season only.

4. The utilities should be authorized to spend up to \$14 per core customer for the 2006/2007 winter season, or up to the amount requested in their respective petitions on hedged instruments – whichever is lower.

5. Each utility should be ordered to submit to DRA and the Energy Division a report, no later than April 1, 2007, that provides information about their hedging programs as set forth herein.

6. Application 00-06-023 and Application 02-10-040 should be closed.

ORDER

IT IS ORDERED that:

1. The May 5, 2006 petition of Pacific Gas & Electric Company (PG&E), the May 17, 2006 emergency petition of San Diego Gas & Electric Company (SDG&E), and the May 18, 2006 emergency petition of Southern California Gas Company (SoCalGas) to modify Decisions (D.) 05-10-015, D.04-01-047, D.05-10-043, D. 02-06-023 and D.03-07-037 are granted as set forth in the following ordering paragraphs.
2. The hedging plans of PG&E, SDG&E and SoCalGas, which are part of their respective petitions and which were filed under seal, are approved.
3. D.04-01-047 is modified to include the following ordering paragraphs:
 - a. To provide much-needed supplemental protection from possible dramatic natural gas price increases during the upcoming winter of 2006-2007, and the potential market disruption caused by seasonal hurricane activity, PG&E is hereby authorized to purchase supplemental hedges in 2006.

The level of the hedges and the expiration dates thereof are specified in the Gas Hedging Implementation Plan attached as confidential Appendix B to PG&E's Petition for Further Modification, dated May 5, 2006.

- b. The costs associated with the approved supplemental hedges placed under PG&E's Petition for Further Modification of D.04-01-047 and for Modification of D.05-10-015, filed May 5, 2006, including costs for hedging already entered into by PG&E for the 2006-2007 winter season as of the date of this order, shall be paid by PG&E's core procurement customers and included in PG&E's monthly core procurement rates. PG&E shall modify its existing Emergency Core Gas Hedging subaccount in the Purchased Gas Account (PGA) to track these costs, and such costs shall flow directly to PG&E's core procurement customers.
 - c. All payouts associated with these hedges placed under PG&E's Petition for Further Modification of D.04-01-047 and for Modification of D.05-10-015, filed May 5, 2006, shall flow directly and entirely to PG&E's core procurement customers in the year in which the payout occurs. PG&E shall track the payouts in the same PGA subaccount described in the above paragraph.
 - d. Neither the costs nor the payouts associated with the supplemental hedges placed under PG&E's Petition for Further Modification of D.04-01-047 and for Modification D.05-10-015, filed May 5, 2006, will be shared by PG&E's shareholders.
 - e. PG&E is authorized to spend up to \$14 per core customer for the 2006/2007 winter season, or up to the amount requested in its petition for modification of D.05-10-015 on hedged instruments – whichever is lower. This limit shall not include hedging instruments commonly known as "swaps."
4. D.03-07-037 is modified to include the following ordering paragraphs:
- a. To provide much-needed supplemental protection from possible dramatic natural gas price increases in the wake of Hurricane Katrina and Rita, SDG&E is hereby authorized to

purchase additional hedges in 2005 and 2006 for the 2005-2006 winter. The level of the hedges and the expiration dates thereof are specified in the Gas Hedging Plan attached as confidential Addendum B to SoCalGas and SDG&E's emergency petition to modify D.02-06-023 and D.03-07-037 dated October 11, 2006. To provide much-needed supplemental protection from possible dramatic natural gas price increases during the winter of 2006-2007, SDG&E is hereby authorized to purchase additional hedges in 2006 and 2007 for the 2006-2007 winter. The level of hedges and the expiration dates thereof are specified in SDG&E's 2006-2007 Winter Hedging Plan attached as confidential Addendum A to SDG&E's Emergency Petition for Further Modification of Decision No. 03-07-037, for Modification of Decision No. 05-10-043, and Request for Expedited Treatment dated May 17, 2006. SDG&E's hedging plan is limited to the winters of 2005-2006 and 2006-2007.

- b. All costs and benefits associated with the approved Gas Hedging Plan shall flow directly to SDG&E's core gas customers.
- c. All costs and benefits associated with the Gas Hedging Plan for the 2005-2006 winter already entered into by SDG&E at the time of D.05-10-043 shall also flow directly to core customers. All costs and benefits associated with the Gas Hedging Plan for the 2006-2007 winter already entered into by SDG&E at the time of this order shall also flow directly to core customers.
- d. Neither the costs nor benefits associated with these hedges will be shared by SDG&E's shareholders.
- e. All transactions associated with the approved Gas Hedging Plan shall be separately recorded and identified in monthly and annual reports filed by the utilities to the Commission. In addition, supplemental reporting on a more current basis will be provided to the Commission staff.
- f. SDG&E is authorized to spend up to \$14 per core customer for the 2006/2007 winter season, or up to the amount requested in its petition for modification of D.05-10-043 on hedged

instruments – whichever is lower. This limit shall not include hedging instruments commonly known as “swaps.”

5. D.02-06-023 is modified to include the following ordering paragraphs:

- a. To provide much-needed supplemental protection from possible dramatic natural gas price increases in the wake of Hurricane Katrina and Rita, SoCalGas is hereby authorized to purchase additional hedges in 2005 and 2006 for the 2005-2006 winter. The level of the hedges and the expiration dates thereof are specified in the Gas Hedging Plan attached as confidential Addendum A to SoCalGas and SDG&E's emergency petition to modify D.02-06-023 and D.03-07-037 dated October 11, 2005. To provide much-needed supplemental protection from possible dramatic natural gas price increases during the winter of 2006-2007, SoCalGas is hereby authorized to purchase additional hedges in 2006 and 2007 for the 2006-2007 winter. The level of hedges and the expiration dates thereof are specified in SoCalGas' 2006-2007 Winter Hedging Plan attached as confidential Addendum A to SoCalGas' Emergency Petition for Further Modification of Decision No. 02-06-023, for Modification of Decision No. 05-10-043, and Request for Expedited Treatment dated May 18, 2006. SoCalGas' hedging plan is limited to the winters of 2005-2006 and 2006-2007.
- b. All costs and benefits associated with the approved Gas Hedging Plans shall flow directly to SoCalGas' core gas customers.
- c. All costs and benefits associated with the Gas Hedging Plan for the 2005-2006 winter already entered into by SoCalGas at the time of D.05-10-043 shall also flow directly to core customers. All costs and benefits associated with the Gas Hedging Plan for the 2006-2007 winter already entered into by SoCalGas at the time of this order shall also flow directly to core customers.
- d. Neither the costs nor benefits associated with these hedges will be shared by SoCalGas' shareholders.

- e. All transactions associated with the approved Gas Hedging Plan shall be separately recorded and identified in monthly and annual reports filed by the utilities to the Commission. In addition, supplemental reporting on a more current basis will be provided to the Commission staff.
 - f. SoCalGas is authorized to spend up to \$14 per core customer for the 2006/2007 winter season, or up to the amount requested in its petition for modification of D.05-10-043 on hedged instruments – whichever is lower. This limit shall not include hedging instruments commonly known as “swaps.”
- 6. Each utility shall submit a report to the Energy Division and DRA, no later than April 1, 2007, that provides information about their hedging programs as set forth herein.
 - 7. The cost of each utility’s hedging activities should continue to be calculated and collected as it is currently, through each utility’s Purchased Gas Account (PGA). Costs should be allocated to all Core customers and the amounts included in the monthly core procurement advice letters filed by each utility.
 - 8. Rulemaking 02-06-041, Application 00-06-023, and Application 02-10-040 are closed.

This order is effective today.

Dated _____, at San Francisco, California.